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NSC FOR SENIOR AFRICA DIRECTOR C. COURVELLE, D. TEITELBAUM
TREASURY FOR OREN WYCHE-SHAW, STATE PASS USAID FOR MARJORIE
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E.O. 12958: DECL: 12/31/2009

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SUBJECT: CURRENCY AUCTIONS BECOMING IRRELEVANT

Classified By: Ambassador Christopher Dell for reasons 1.4 b/d

11. (C) Summary: Foreign exchange demand at the Reserve Bank (RBZ),s 14-month-old currency auctions is now twelve-times greater than supply. Traders are migrating in droves to the illegal parallel market. After the March 31 parliamentary elections, the GOZ will either have to resolve the supply/demand discrepancy through a hefty devaluation, or accept that its much-ballyhooed auctions are giving way to a resurgent parallel market. End Summary.

The Auction,s Achievements - From the GOZ Standpoint

12. (C) Through the introduction of RBZ currency auctions in January 2004 and stricter enforcement against parallel trading, the GOZ has accomplished several goals. First, the GOZ has made exchange rate management, rather than monetary supply growth, its primary tool to contain inflation. Through this approach, the GOZ has been able to contain inflation somewhat while increasing money supply (about 200 percent annualized during the period) to finance government spending. Since the auction,s inauguration, year-to-year inflation has fallen from 623 to 127 percent. Although growth has remained negative, and the few productive sectors of the economy are wilting under the strain of financing the government,s interventionist policies, lower inflation has become for political purposes the GOZ,s prima facie evidence of a recovering economy.

13. (C) Second, the auction system has allowed RBZ Governor Gideon Gono to concentrate economic power in his hands. The GOZ has ensured that, until recently, foreign exchange inflows and outflows largely pass through official rather than private channels. By becoming the country,s only legal currency broker, the RBZ increased the share of export revenue it handled from US\$300 million in 2003 to US\$1.7 billion in 2004. (N.B. In its official media, the GOZ has often mischaracterized this redirection of inflows as a five-fold increase in exports.) Under the auction system, the RBZ governor has been able to select the importers that obtain discounted forex through the only legal channel, a near-guarantee of success. Furthermore, he has turned private banks and international transfer agents into RBZ agents, since they can no longer trade currencies and move forex freely.

14. (C) Third, GOZ insiders have gained an additional pretext to harass political adversaries for violating the Exchange Control Act, i.e., trading on the parallel market or transferring funds out of Zimbabwe. Many arrests seem to arise out of factional battles within the ruling ZANU-PF. Since January 2004, the GOZ has detained hundreds of prominent Zimbabweans for exchange transgressions, and Finance Minister Chris Kuruneri has already spent a year in jail awaiting formal charges. The GOZ has accused Kuruneri and others for offenses prior to January 2004, when affluent Zimbabweans traded openly in the parallel market. (N.B., Official prohibitions such as the Exchange Control Act were already in place before January 2004, but the GOZ tolerated a ubiquitous parallel market. It was the only forex source only for imports, foreign tuitions, travel and other purposes.)

The Auction,s Unraveling

15. (C) According to the RBZ, it has increased available funds at the biweekly auctions from US\$ 8 to 11 million since January 2004. However, demand has far outstripped supply. Of 5,804 importers who competed for forex at the March 21

auction, only 102 succeeded. Moreover, we know of no firm that has succeeded in weeks. Reportedly, most of the country's forex is being routed to the fuel sector to ensure adequate supplies in advance of the election. At the same time, the Z\$6,000:US\$ auction rate has become more and more implausible. Even according to official statistics (which are not always reliable), cumulative inflation from January 12, 2004-March 6, 2005 has run about 160 percent while the zimdollar's official rate has actually appreciated by 8 percent (from Z\$6500 to 6000:US\$).

16. (C) After the GOZ lightened its enforcement against parallel traders two months ago, the zimdollar began to slide rapidly toward its intrinsic, inflation-adjusted value. Since then, the parallel exchange rate has moved from approximately Z\$9,000 to 15,000:US\$, a devaluation of 67 percent. Parallel trading has become more commonplace, with most Zimbabwean businesses forced to look there for forex. One trader even confided to us last week that he has started handling exchanges for the South African embassy and several RBZ staffers. With the exceptions of fuel and electricity, prices for local goods and services reflect parallel rates.

The GOZ's Dilemma: Devaluation or Parallel Market

17. (C) To make the auctions relevant again, the GOZ would have to stomach a major devaluation of the official exchange rate. RBZ officials have been telling us for months that devaluation will follow the March 31 parliamentary elections, but we are not at all certain that the GOZ will move far enough, fast enough to draw inflows away from the parallel market. A small devaluation, for instance to 9000, might simply cause further depreciation of the parallel rate especially since the GOZ is unlikely to alter its underlying state-centric economic policies.

18. (C) A better but probably less likely scenario would be for the GOZ to leave the auctions intact for certain transactions, such as parastatal operations, but to tolerate parallel trading for the economy as a whole. This would prove an important step toward exchange liberalization, as a largely decriminalized parallel market would in effect represent a self-adjusting, floating rate. It would make exporters more competitive and enable importers to acquire forex through an orderly, predictable process. The continued existence of an official rate would, however, remain a source of official corruption.

Dell